

GLOBAL CAPITALISM

Making it work

The much-trumpeted triumph of global capitalism has been looking tarnished in recent weeks. Here Jeffrey Sachs offers a new way forward*

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THE collapse of the emerging markets and its ricochet effect on advanced economies may not be the end of globalisation. But it is certainly the end of an era. Since the miraculously peaceful fall of communism, Washington has aspired to stage-manage the transition to global capitalism. America, in concert with Europe and Japan, would ensure security and arrange deals on world trade and regional stability; the International Monetary Fund would do the financial plumbing, to connect Russia, Africa, Latin America and South Asia, back to the world economy.

This approach is rapidly collapsing. In the short term, there is now a crying need for globally co-ordinated interest-rate cuts to shore it up. But in the longer term, if the current crisis is used creatively, a sounder basis for globalisation is required. If neither of these things is done, we may be entering a highly dangerous new period of confusion and confrontation.

At the simplest level, the story is an old one: you just can't find a good plumber when you need one. The IMF, and the institutions that it co-ordinated (the World Bank, the regional development banks, the Paris Club of creditors), have proved technically ill-equipped for the challenge. But the IMF was having too much fun running 80 countries in the world to take heed. Organised as a secretive institution, all of its programmes carefully stamped "confidential" until recently, the IMF has lacked moderation, outside review, and the competitive pressures needed to keep it up to date. The American government has found it a handy instrument of financial diplomacy and quick-disbursing funds, but did not realise that its repeated technical failures could threaten the greater vision.

At a deeper level, the problem is one of basic approach. America has wanted global leadership on the cheap. It was desperate for the developing world and post-communist economies to buy into its vision, in which globalisation, private capital flows and Washington advice would overcome the obstacles to shared prosperity, so that pressures on the rich countries to do more for the poorer countries could be contained by the dream of universal economic growth. In this way, the United States would not have to shell out real money to help the peaceful reconstruction of Russia; or to ameliorate the desperate impoverishment and illness in Africa. In essence, America has tried to sell its social ethos: the rich need not help the poor, since the poor can enjoy rising living standards and

someday become rich themselves.

Washington became skittish at anything or anybody that challenged this vision. When developing-country leaders pointed out that development was much harder than it looked; that their economies were falling further behind in technology; that they were being destabilised by financial flows they could neither track nor understand; that falling commodity prices were taking them further from the shared prosperity that they had been promised; that unattended disease was ravaging their societies; that the wreckage of Soviet communism would take real aid, not just short-term loans to overcome; or that they were still drowning in debt ten years after America acknowledged the need for debt relief; all these honest reflections were taken as hostile challenges to the vision of shared prosperity, because they put at risk the notion of cost-free American leadership.

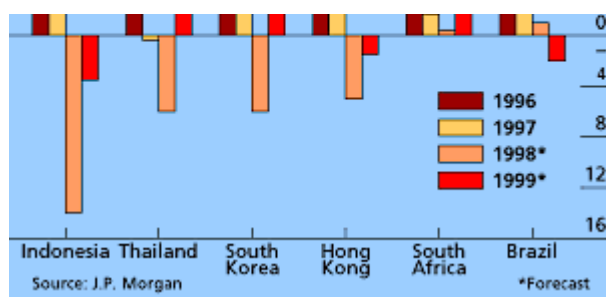
Time for a G16

As a result, for a decade we have had a phony Washington consensus on how to achieve shared prosperity—and almost no real discussions between rich and poor countries on the challenges facing a world of greater income inequality than ever before in history. The Americans seem to fear the potential budgetary costs of being honest about the manifold obstacles to global development, and they fear the consequences of stirring up isolationists in Congress and in the wider public. Such fears are overblown. The American people, no less than any others, are deeply worried about a world increasingly lacking convincing answers on the way forward.

Instead of the next G8 summit, we should immediately begin preparations for a G16 summit: the G8 plus eight counterparts from the developing world. Such a meeting would not seek to dictate to the world, but to establish the parameters for a renewed and honest dialogue. One standard should apply for participation: democratic governance, since the only reliable way to build for the future is through participatory political processes. Four core members of the eight developing countries would be Brazil, India, South Korea and South Africa. We can hope that soon a democratic Nigeria will be in place to help represent the 200m people of West Africa. Smaller democratic countries that carry disproportionate credibility in the world, such as Chile and Costa Rica, would be valued participants.

A sense of shared stewardship between rich and poor could do a great deal to calm panicky financial markets. Part of the problem is that naive 25-year-old investment bankers who do not know much about world politics think that the will to reform hangs by a thread in emerging markets; that Russia will bolt from the world scene; that India has turned inward; that Malaysia is irredeemably xenophobic; and that South Africa lacks the stomach to reform. These are all false propositions—these countries deserve the benefit of the doubt. But there is no convincing way to prove this. Getting them to pay obeisance to the IMF has not worked, since IMF dictates from Washington rile up local politics.





Even more important than calming panicked markets is giving poorer countries a stake in a shared future. Global capitalism genuinely is the best chance for the developing world to gain a foothold on the economic-growth ladder; but with current institutions, global capitalism will not succeed widely enough or credibly enough to create a stable world system. Giving the developing world (that is, 85% of humanity) a serious role in shaping the new global institutions is the surest way to achieve that end. As Paul Samuelson once said, the best way to convince somebody of something is to give them a half-finished theorem, and let them fill in the rest.

A development agenda

Precisely because intensive discussion is needed more than diktats, there is no merit in offering a detailed blueprint for global reform: the process of discussion is part of the solution. Yet the G16 summit would need an opening agenda, a basis for reflection, debate, and negotiation. So herewith, a modest pair of proposals.

The first concerns **global financial markets**. The summit should take up the question of international financial reform. Washington's dream of a quick move to global financial liberalisation is in ruins. It is hard to believe that just a year ago the IMF was trumpeting a new global commitment to unfettered capital flows. Almost all observers now concede that premature liberalisation of capital markets (often pushed by the IMF itself) was one cause of the current crisis. It was financial-market "reform" that allowed Thai and South Korean banks to tap into short-term international loans in the early 1990s, thereby bringing these banks together with excited young investors who were happy to be in Bangkok and Seoul for the first time. Hundreds of billions of dollars of loans flooded in. Now, the panicked flight of such loans is at the root of the emerging-markets debacle.

The IMF worked mightily, and wrongheadedly, to make the world safe for these short-term money managers. The IMF bought into the investment bankers' mantra: exchange-rate stability above all else. The *Wall Street Journal* parroted an even stronger line in favour of wholly fixed exchange rates. After all, if central banks devote their reserves to a defence of the exchange rate, and if the IMF dedicates its funds to the defence of central banks, lending to emerging markets is like shooting fish in a barrel. Or so it seemed—until a stampede began in the other direction.

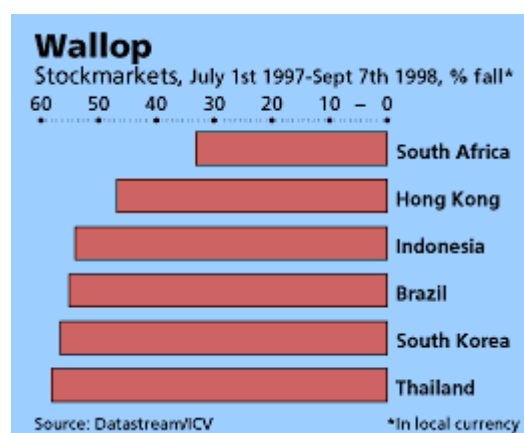
The IMF encouraged central banks from Jakarta to Moscow to Brasilia to raise interest rates to stratospheric levels to protect their currencies, lest they lose the confidence of the money managers. Of course the money managers could see one step beyond the IMF: investors do not gain confidence when short-term rates are pushed to dozens of percent, as they have been in Russia, South Korea, South Africa and Brazil at some points this year. The more these economies tried to

defend their currencies, the more they incited panic.

Milton Friedman was right, as usual, about two big things. First, let exchange rates float. It is neither worthwhile nor feasible to twist monetary policy to soothe panicky investors, especially at the cost of internal depression. (The only real exception to floating rates comes at the start of stabilisation from extreme inflations, when exchange-rate targeting is more efficient than monetary targeting). Second, small shocks can have huge effects when they destabilise fractional-reserve banking systems. In his classic monetary history of the United States, Professor Friedman argued that banking panic, unattended by the Fed, created the Great Depression. So this free-marketeer has long championed government-mandated deposit insurance as a protection against bank runs.

We now need an international equivalent, to forestall panics in international lending. The best idea around is that developing countries should impose their own supervisory controls on short-term international borrowing by domestic financial institutions. To avoid panicky capital outflows, it is best to prevent banks from exposing themselves to excess short-term indebtedness in the first place. Chile does this by taxing short-term flows; other approaches may be worth exploring.

We also need vastly improved ways for creditors and debtors to extricate themselves from trouble once a crisis has begun. Otherwise East Asia is going to be buried in bad debt for half a decade or more. Already, Washington is complacently writing down its medium-term forecasts of Asian growth. This is wrongheaded.



Asian factories, which fuelled two decades of rapid growth, have not suddenly vanished. They have been smothered in bad debts, which prevent companies from getting working capital to keep producing. The IMF has no answers, other than case-by-case bankruptcy proceedings, which already look like a recipe for a lost decade of growth. Much bolder approaches are needed, such as across-the-board debt write-downs and mass conversions of debt to equity.

The second proposal concerns **conditionality and foreign aid**. The IMF and the World Bank have behaved with stunning arrogance in developing countries. The sequence is familiar: the IMF's negotiating positions are settled in Washington; the mission team goes to the client country to convey Washington's conclusions; the financial markets wait breathlessly to see whether the country will comply; the American government repeats the mantra "Obey the IMF"; and journalists

assess the “seriousness” of reforms according to whether countries bite the bullet to carry out the IMF dictates, whatever they are.

This process is out of hand. It has undermined political legitimacy in dozens of developing countries, especially since the IMF is often happy to conspire with governments to make end runs around parliaments in the interests of “reform”. The contents of IMF programmes are too flawed to be a standard of good or bad performance. Markets are realising this, so IMF programmes do less and less to rally them. Publicly breaking with the IMF, however, still carries a huge cost in market panic.

Help and self-help

A G16 summit should take up fundamental reform of the international assistance process itself. The aim should be to restore legitimacy to local politics, and abandon the misguided belief that the IMF and World Bank can micro-manage the process of economic reform.

There is a better model of conditionality than the current Washington-based approach. A large part of foreign aid should be channelled through regional organisations (such as ASEAN in South-East Asia, Mercosur in Latin America, or the SADC in Southern Africa) that would put peer pressure rather than Washington pressure on their members. This is essentially the mechanism that underlay the most successful aid programme in history, the Marshall Plan. The Americans told the Europeans to work out the details on allocating aid. Countries watched each other; they prevented backsliding; they channelled funds into collective infrastructure; they deepened institutions of regional co-operation.

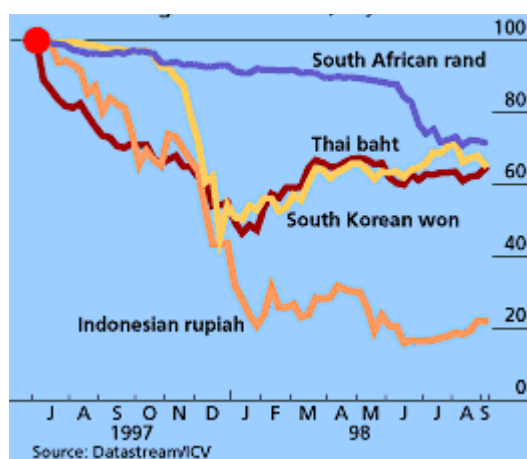
Even more fundamental questions need to be asked about aid. What function does it fulfill, when long-term capital is available to build roads, telecoms networks, ports and power plants? It cannot be merely to keep the World Bank in operation or to lend governments new money to pay off old debts. The answer is that there is a continuing need for aid, almost certainly on a bigger scale than ever before—but of a completely different kind to today’s.

Many current aid programmes could be scaled back by following three steps. First, the agony of the debt crisis that began 20 years ago should be ended, by simply cancelling most of the debt owed by the poorest countries. The current strategy, known as the Highly Indebted Poor Country (HIPC) initiative, is too slow and too stingy. Under the HIPC, debts are cancelled after years of delay and only to a point that leaves the countries still heavily in the red (post-cancellation debt is meant to equal 200% of exports). Maybe it is the Washington bureaucrats’ ideal: countries do not collapse, but they never get better.

Second, all infrastructure aid that can be privately financed with long-term capital (ie, most big projects) should be ended. The World Bank could then privatise a large part of its operations. And third, IMF bailouts of the sort that have failed in Asia and Russia should be ended. They do not work. And they would not be needed if exchange rates floated, if supervisory standards limited short-term capital inflows and if orderly private workouts rather than public bailouts were encouraged.

Bang

Currencies against the dollar, July 1st 1997=100



This would then enable aid flows to be redirected. Aside from humanitarian emergencies, and special cases like post-conflict countries or the end of 75 years of Soviet communism, the main function of aid should be to respond to the fact that private markets do not attend to many international public goods—goods that heavily influence the success or failure of the poorest countries. Much of the developing world is burdened by disease and environmental stresses that are deeply debilitating the lives of millions of people. Malaria, for instance, afflicts around 500m a year, but global public spending on a vaccine has been less than ten cents per case in recent years. The WHO has wisely launched a renewed anti-malaria effort, but it must be financed. Similarly, hookworm undermines the health of millions of people throughout the tropics, but almost no public money is spent on basic epidemiology or vaccine research.

The developing world lacks basic scientific and technical means to address the environment, health, population and agriculture. Ever more hard economic evidence suggests that development problems in the poorest countries come not merely from a lack of political will, as fondly believed in Washington, but also from a lack of knowledge of what to do. The heady technological advances of the rich economies do not automatically translate into benefits for the impoverished tropics.

So we need the World Bank not as yet another bank, but as our pre-eminent international institution for mobilising the knowledge to address the problems of the developing world. Yet the World Bank currently makes its money from loans. It finds itself stuck in a banking business where it is little needed, and not in the knowledge business where it could truly serve the world. Restructuring the Bank, so that it had the means to mobilise real knowledge creation, would cost a lot. This is part of the price tag feared by the American government. The world will have to decide whether to remain on the cheap, or to make the investments in knowledge that could promote a more prosperous future.

Getting there

Do the developing countries want to change the system? The current one has, after all, become a relationship of mutual dependency. Developing-country governments, even those that recognise the shortcomings of the Washington advice, wait patiently for the IMF and World Bank to send their next team of experts. They are addicted to aid flows, partly to refinance old debts; they are resigned to having little voice and little scope for initiative. Washington will not

easily cede the initiative either. Yet in the end, the developing countries must become masters of their own fate, or they will be dragged under in a widening spiral of financial distress.

Even with all of the turbulence and value destruction of the past year; even with the failures of IMF-World Bank programmes in Africa in the past decade; even with the collapse of the post-communist transition in Russia; even with all of these things, no developing countries are closing the doors on markets and globalisation. In Malaysia and Russia, certainly, there has been a backlash. But even there, policymakers know they cannot get by without the outside world. They know that technology and capital can come only from outside; and they know that only markets can deliver the chance of sustained growth.

In short, developing countries are not trying to overturn Washington's vision of global capitalism, but rather to become productive players in it. Only if they are shut out might they change their minds. But the developed world should not fear dialogue with the developing world. It should join it urgently, for our mutual well-being.

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